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Montana's Public Retirement Systems

A Legislator's Guide
June 1997

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**Montana's
Public Retirement Systems
A Legislator's Guide
June 1997**

Committee on Public Employee Retirement Systems

1995-1997

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CHAPTER 1

OVERVIEW AND PERSPECTIVE

Overview

Montana's public employee retirement systems include eight statewide public retirement systems administered by the Public Employees' Retirement Board, the Teachers' Retirement System (TRS) administered by the Teachers' Retirement Board, the University System's Optional Retirement Program (ORP) administered by the Board of Regents, and locally administered police and fire pension trust funds. These retirement systems cover more than 56,000 state, university, school district, county, and city employees. There are nearly 46,000 active plan participants and nearly 19,000 retirees and beneficiaries.

Except for the ORP, each of Montana's retirement plans is a defined benefit plan. The Public Employees' Retirement System (PERS), the largest of Montana's eight statewide systems under the Public Employees' Retirement Board, is a hybrid plan with a money purchase (defined contribution) feature. The ORP is a pure defined contribution plan. These plan types and specific information on each of Montana's public retirement plans are discussed in this guide.

Membership

A public employee becomes a member of one of the retirement plans on the day the employee is hired. Except for the volunteer firefighters' retirement plan, which is funded entirely from the state general fund, both employees and employers contribute to the plans (i.e., they are "cost-sharing" plans). Employee contributions are tax-deferred and, along with employer contributions, are automatically made each pay period. Contribution amounts are set in statute by the legislature. In the defined benefit retirement plans, when an employee leaves public service, the employee has the option of leaving contributions on account in the retirement plan or withdrawing employee contributions plus interest. Once vested (i.e., a contributing member for 5 years), an employee is entitled to receive plan benefits whether or not the employee stays in public service long

enough to receive a full (normal) retirement benefit. As is typical of most large defined benefit plans, Montana's defined benefit plans also provide survivor and disability benefits.

Assets and Liabilities

Combined assets of Montana's public retirement systems amount to more than \$3 billion, while liabilities total nearly \$4 billion. Of the total liabilities, less than \$1 billion of the liabilities are unfunded, i.e., not funded in the present by current assets.* These unfunded liabilities are being amortized over specified time periods (each less than 30 years), much like a mortgage. Each of Montana's public retirement systems is actuarially sound. (For a discussion of actuarial soundness and assessing the fiscal health of a retirement plan, see Chapter 5.)

The retirement funds of the defined benefit plans are constitutionally protected trust funds. Each plan's administrative board members act as the plan's responsible fiduciaries. Each defined benefit plan's assets are managed and invested by the Montana Board of Investments.

The University System contracts with an investment management company to manage ORP participant assets. Each ORP participant makes his or her own investment choices from a selected menu of options.

The legislature is the public body ultimately responsible for ensuring that each of Montana's public retirement systems remains soundly funded and equitably administered.

Recent Legislative Oversight Activities

During the 1991 Legislative Session, the Legislature passed a study resolution to establish a Joint Interim Subcommittee on Public Employee Retirement Systems to study the retirement systems and make public policy recommendations. The Subcommittee concluded that the complexity of issues, several different public

* These figures are as of June 30, 1996, prior to the 1997 Legislative Session.

plans, and an average of 40 to 50 retirement bills each legislative session made it difficult for the legislature to enact consistent and equitable retirement policy. To help remedy this, the Subcommittee recommended a permanent oversight committee to review retirement legislation prior to each legislative session, to establish guiding principles for enacting sound retirement policy, and to publish a legislator's guide on Montana's public retirement systems.

Responding to the Subcommittee's recommendation for an oversight committee, the 1993 Legislature enacted a statutory, but temporary, Committee on Public Employee Retirement Systems (CPERS). This Committee adopted guiding principles and screened and reported on 11 retirement proposals prior to the 1995 Legislative Session. The Committee also contracted for a study of options for providing cost-of-living (COLA) increases to retirees. As a result of the COLA study, the CPERS supported a postretirement proposal, which was ultimately requested by the Governor, to provide public retirees with a Guaranteed Annual Benefit Adjustment (GABA) instead of a COLA. However, the GABA legislation failed during the final days of the 1995 Session. The 1995 Legislature decided to renew CPERS and extended the Committee's termination date to June 30, 1997.

The 1995-1997 CPERS adopted guiding principles, carefully reviewed and reported on 18 retirement proposals, including a revised GABA proposal, and initiated an examination of whether Montana's PERS should be modified or converted from a hybrid defined benefit plan to a defined contribution plan.

The 1997 Legislature approved two CPERS-requested bills, House Bill No. 90 and House Bill No. 91. House Bill No. 90 directs that a legislative committee design a new or modified PERS in order to provide for more plan flexibility, portability, and employee responsibility. The committee is to also develop an implementation schedule for the recommended changes. The bill appropriated \$80,000 for the committee's work. (See Chapter 6 for a discussion of issues related to moving from a defined benefit plan toward a defined contribution plan.)

House Bill No. 91, as amended, renewed CPERS by extending the Committee's termination date to June 30, 1999. This bill allowed for CPERS to be the committee designated to undertake the HB 90 work to design a new or modified PERS.

The CPERS will continue to be responsible for reviewing and reporting on each retirement proposal that may be introduced during the 1999 Session. The following statute sets forth CPERS' duties and responsibilities:

"5-21-105. (Temporary) Duties of committee – committee review and report. (1) The committee on public employee retirement systems shall:

(a) consider the fiscal soundness of the state's public employee retirement systems, based on reports from the teachers' retirement board and the public employees' retirement board, and study and evaluate the equity and benefit structure of the state's public employee retirement systems;

(b) establish principles of sound fiscal and public policy as guidelines;

(c) as necessary, develop legislation to keep the retirement systems consistent with sound policy principles;

(d) solicit and review proposed statutory changes to any of the state's public employee retirement systems;

(e) report to the legislature on each legislative proposal reviewed by the committee. The report must include but is not limited to:

(i) a summary of the fiscal implications of the proposal;

(ii) an analysis of the effect that the proposal may have on other public employee retirement systems;

(iii) an analysis of the soundness of the proposal as a matter of public policy;

(iv) any amendments proposed by the committee; and

(v) the committee's recommendation on whether the proposal should be enacted by the legislature.

(f) attach the committee's report to any proposal that the committee considered and that is or has been introduced as a bill during a legislative session; and

(g) publish, for legislators' use, an information book on the state's public

employee retirement systems.

(2) The committee may specify in its study plan, which may be adopted and amended by a majority vote of committee members, the date by which proposals affecting a retirement system must be submitted to the committee. (Terminates June 30, 1997--sec. 2, Ch. 552, L. 1995.)"

CPERS Membership

In originally establishing CPERS, the legislature specified membership criteria aimed at ensuring continuity between interims and sessions. Appropriate members from session standing committees must be appointed to CPERS during the interim according to the following statute:

"5-21-101. (Temporary) Committee on public employee retirement systems – appointment. (1) There is a committee on public employee retirement systems.

(2) The committee consists of four members of the senate appointed by the committee on committees and four members of the house of representatives appointed by the speaker of the house.

(a) No more than two of the committee members from each house may be members of the same political party.

(b) At least two committee members from each house shall serve on the standing committee to which retirement bills are regularly assigned during a regular session. One senate member shall serve on the senate finance and claims committee. One house member shall serve on the house appropriations committee.

(c) No more than two members appointed from each house may be public employees aside from their legislative service."

At the printing of this guide, the 1997-1999 CPERS is beginning to develop a work plan for the interim.

About This Guide

This guide is designed to inform legislators about Montana's public retirement systems and relevant policy issues. The information presented is intended to provide background, reference material, and context when legislators examine more detailed information available from the boards administering the plans or when legislators engage in discussions on retirement issues. This guide presents background on retirement plans in general, summarizes each of Montana's public retirement plans, and addresses funding and policy issues. However, the adequacy of retirement benefits is not addressed.

CHAPTER 2

PRIMER ON RETIREMENT PLANS

Purpose of Retirement Plans

Planning for retirement is only part, though an essential part, of a person's total financial planning strategy. Retirement plans exist solely to provide benefits in retirement, not to provide a tax-sheltered savings account. A retirement plan is a vehicle that assures a person will have an on-going source of income when the person is no longer working. Consequently, retirement plans require that a person meet certain membership and retirement eligibility criteria.*

Experts agree that, to live comfortably in retirement, today's retiree needs a monthly income of about 80% of the salary earned during the employee's final year of work. Clearly, serious long-term planning is required to achieve an 80% income replacement in retirement. More than one plan or vehicle is necessary. Many types of retirement plans and a variety of insurance and investment products make retirement planning a complex affair. Social security, employer-sponsored retirement plans, deferred compensation plans, and personal investments are all part of the equation in achieving a secure and adequate retirement income.**

Responsibility

Pension plans were originally a financially expedient way to compensate employees for services rendered. Later, this rationale evolved into a view that employers were socially responsible for providing employee pensions. As pension plans evolved, so did government regulation to ensure pension plans remained fiscally sound, that contracts were honored, and that people were not discriminated against. Finally, as employers and the government provided new

*Bleakney, Thomas P., F.S.A., *Retirement Systems for Public Employees*, Pension Resource Council, University of Pennsylvania Press, 1991 edition, p. 10 and p. 33. National Conference of State Legislatures, *Public Pensions: A Legislator's Guide*, NCSL, Washington D.C., July 1995, pp. 1-3.

** _____. "Retirement Planning Starts Today." *Investment Watch*, Winter 1996. pp. 2-3.

and better incentives to employees to defer compensation and employers began to require employee contributions to the employer-sponsored plans, employees became more and more responsible for their own retirement planning.

As a practical matter, providing for retirement income is a shared concern of employers, employees, and the government. Traditionally, government has discharged its responsibility through regulation and enactment of social security and public assistance programs. In contrast, employers use retirement plans to provide work incentives and further the company's financial interests. Therefore, there are unique public policy questions involved when the government is also the employer.*

Retirement plans oriented on individual needs and responsibilities are a relatively recent development.** New public policy questions are being debated as the role of governments, employers, and individuals are being reviewed, especially in the public sector.

Plan Categories

There are basically two categories of retirement plans, defined benefit (DB) plans and defined contribution (DC) plans. Each category reflects a different retirement philosophy.

■ Defined Benefit Plans

Defined benefit (DB) plans promise a member a specified, formula-driven monthly benefit when the member retires. Benefits within a DB plan often cover not only retirement, but disability and survivor benefits as well.

There are several types of DB plans, including:

*Bleakney, Thomas, F.S.A., *Retirement Systems for Public Employees*, p. 10.

**Salisbury, Dallas L. "The Costs and Benefits of Pension Tax Expenditures," *Pension Funding & Taxation : Implications for Tomorrow*, Employee Benefit Research Institute, 1994, pp. 85-86; see also Allen, Everett T., *Pension Planning: Pensions, Profit Sharing, and Other Deferred Compensation Plans*, Seventh Edition (Irwin: Boston, Mass.) 1992, pp. 16-17.

- *flat-benefit plans*: providing a fixed dollar amount per year of service;
- *pay-related plans*: providing a benefit as a certain percentage of an employee's pay; and
- *hybrid plans*: combining characteristics of both DB and DC plans.

To pay for defined benefits, contributions are deposited to a pension trust fund. These contributions are invested to increase plan assets. Assets must be sufficient to pay for the defined benefits when those benefits come due. The required contribution amount is determined after an actuarial analysis using mathematical projections. These projections are based on certain economic and demographic assumptions. Different actuarial methods may be used in conducting an actuarial analysis (i.e., a plan valuation). These actuarial valuations determine, among other things, the present value of system assets and projected future costs. Actuarial valuations are conducted regularly to determine a plan's fiscal status and to adjust assumptions based on actual experience.* (See Chapter 5 for a more thorough discussion on actuarial valuations.)

Therefore, in DB plans, (1) benefits are predictable, but costs are not, (2) contributions are pooled and managed so that assets are buffered from market fluctuations, (3) the employer has a contractual obligation to provide promised benefits; and (4) unfunded liabilities -- accrued liabilities that are not covered by current assets-- are typical.

■ **Defined Contribution Plans**

Defined contribution (DC) plans define the amount to be contributed, not the benefit amount to be paid. Individual participants may direct contributions to certain investment options. Upon retirement, the value of each participant's account depends on total contributions plus investment earnings (or losses). The balance of a participant's account may be reinvested or converted to a monthly

*See Mr. Leon LaBrecque, "Defined Benefit to Defined Contribution: Conversion Issues", presented to CPERS, October 26, 1996.

annuity. The amount of the annuity cannot be defined before the person retires because the account balance depends entirely on total contributions, investment performance, and the state of the market when the employee retires. Investment risk and expenses are, therefore, born entirely by the employee. A DC plan has no unfunded liabilities and does not rely on actuarial projections about the future. Thus, in DC plans, (1) costs are known, but benefits are not, (2) the account balance or the annuity paid is subject to market fluctuations, and (3) the employer is not contractually obligated to provide a certain benefit.

There are several types of DC plans, including the following:

- *money purchase plans*: employer contributions are stated as a percentage of an employee's salary;
- *target benefit plans*: contributions are scaled to achieve a specified retirement benefit, but as a projection only;
- *profit-sharing plans*: employer-sponsored plans (including 401(k) plans, which do not have to be based on company profits);
- *stock bonus plans*: gives employees stock options at a discounted price; and
- *employee stock ownership plans (ESOP)*: gives employees ownership interest in the company.

Public Versus Private Plans

Defined benefit plans are the dominant plan type among public employers. However, trend data shows that DC plans have made some gains among public employers. In 1987, the federal government established a thrift savings plan, which is an optional tax-deferred plan similar to a 401(k), as a supplemental plan to its primary Civil Service and Federal Employee Retirement Systems, which are DB systems. Additionally, the number of state and local government employees

participating in a supplemental DC plan increased from 5% in 1987 to 9% by 1990. Nevertheless, nearly all state and local governments continue to sponsor primary DB plans.* (As will be discussed in Chapter 6, some state governments have expressed interest in moving their primary DB plans to DC plans.)

In the private sector, the typical employee of a medium or large private employer participates in a DB plan and/or a DC plan. In 1993-1994, 90% of full-time state and local government employees were covered by a primary DB retirement plan compared to 56% of private-sector employees. Of the private-sector employees covered by primary DB plans, 45% were also covered by a DC plan.**

Looking at trends in the private sector, between 1985 and 1989, the number of DC plans increased by about 67%. However, the majority of this increase occurred among smaller employers, with the number of new DC plans generally decreasing as plan size increased. The net increase in primary DC plans with 1,000 or more active participants amounted to 0.2% of the total 67% increase. The number of primary DB plans among large employers in the private sector has remained relatively stable.***

Comparison of DB to DC Plans

The underlying difference between DB and DC plans is philosophical. Under DB plans, employers bear the primary responsibility and risk. Under DC plans, employees bear the responsibility and risk. Whether a DB plan or a DC plan will provide public employees with a “better” benefit depends on many factors and is a secondary issue.

Figure 1 provides a thumb-nail comparison of DB and DC retirement plans.

*Employee Benefit Research Institute (EBRI), *Pension Funding & Taxation*, “Public and Private Pension Today: An Overview of the System”, by Celia Siverman and Paul Yakoboski, Washington D.C., 1994, pp. 18-21. More recent data was not available.

**Foster, Ann, PH.D., “Comparing Public and Private Pensions”, U.S. Department of Labor, Bureau of Labor Statistics, January 1996.

***EBRI, *Pension Funding & Taxation*, p. 18.

FIGURE 1*

Comparison: DB vs. DC Retirement Plans		
Issue	DB Plans	DC Plans
Philosophical perspective	Employer responsibility. Employer is obligated to provide a base retirement benefit. Contributions are pooled and debts or gains, usually caused by market fluxuations, are shared by employers in the pool. Unfunded liabilities are typical. Reasonable amortization schedule provides financial security and "shock absorber".	Employee responsibility. Employer responsibility ends with contribution to the plan. Employee bears investment risks and responsibilities. No gains or losses to a shared plan so no amortization schedule and no actuarial valuations.
Flexibility	Less. A DB plan usually provides only the option of how the defined benefit is to be paid out, e.g., as a single life annuity, joint and survivor annuity, term certain, etc.	More. Depending on design, the plan may allow participants to choose contribution amount, investment options, and form of payout.
Portability	Less. Employer contributions are not made to individual accounts so if an employee leaves employment before vesting, the employee is usually not eligible for a retirement benefit or to "take" or "transfer" employer contributions.	More. Employer contributions are made to individual accounts. Money in the account may not be accessible until retirement, but the employee can continue to manage the account. Actual portability depends on the specific provisions of the plan, which may or may not limit transferability.
Investment risk & return	Risk is assumed by the employer. To the extent that assumptions or projections differ from actual experience, the pension funds may experience gains or losses. Pension assets are pooled. Gains and losses are smoothed over a long-term period. Risk is therefore minimized.	Risk is assumed by the employee. Employees may select a risk/return tradeoff to fit personal circumstance.
Who benefits	Career employee. Typically, longer-term or older employees benefit most.	Short-term employee. Typically, shorter-term and younger employees benefit most (depending on investment choices).
Unfunded liabilities	Typical. Current guidelines say that amortization in 30 years or less is an acceptable amortization schedule.	None.

*Primary Sources: LaBrecque, Leon. "Defined Benefit to Defined Contribution: Issues of Conversion", October 26, 1996; D.A. Davidson & Co., "Retirement Plans," overview for CPERS, 1996; Everett, *Pension Planning*, pp. 73-82; Hubbard, "The Tax Treatment of Pensions," *Pension Funding & Taxation*, Employee Benefits Research Institute, 1994, pp. 45-47; Crane, Roderick B. "DC Plans Offer Benefits to Public Plans, Participants," *Pension Management*, May 1995.

Comparison: DB vs. DC Retirement Plans		
Issue	DB Plans	DC Plans
Pension security	Higher. The benefit amount is guaranteed and can be counted on. Pension funds are buffered against large market losses.	Lower. The actual benefit amount is not known in advance. More susceptible to market losses.
Administrative costs	Paid by plan sponsors.	Paid by plan participants.

Hybrid Plans

As previously mentioned, there are different types of DB and DC plans. Additionally, there are hybrid plans where the line between a DB and DC plan has been “blurred” by the inclusion of both DB and DC features. For example, in PERS, a member’s benefit is calculated under both a DB formula and a DC (money purchase) formula and the member is paid the higher of the two. Career employees or older employees (45 years old or older) do better under the DB formula, while shorter-term employees do better under the DC formula. (See Chapter 6 for a discussion of issues related to modifying PERS to further enhance the DC aspects of the PERS retirement plan.)

Pension Regulation and Tax Treatment

Sections 400 through 419 of Title 26 of the Internal Revenue Code (IRC) and pursuant federal administrative laws regulate public and private pension plans. Plans may be referred to according to the IRC section under which the plan is qualified (e.g., a 401(k) plan, a 403(b) plan, a 457 plan, etc). Qualified pension plans are plans that comply with the IRC and applicable provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The ERISA specifies nondiscrimination standards and regulates reporting an accounting procedures, etc. Qualified plans receive favorable tax treatment; nonqualified plans do not.

Except for certain administrative and accounting standards, ERISA does not apply to public pension plans.* However, public plans must be qualified under various sections the tax code in order for employee contributions and accruing benefits to be tax-deferred.

Specific Plans Compared

Figure 2 summarizes some of the more common private and public retirement and deferred compensation plans.

* Hubbard, "The Tax Treatment of Pensions," *Pension Funding & Taxation*, Employee Benefits Research Institute, 1994, pp. 45-47

FIGURE 2
Comparison of Plans by Type

PLAN TYPE	OBJECTIVE	WHO MAY PARTICIPATE	CONTRIBUTION LIMITS	SPECIAL CONSTRAINTS
Private employer plans				
Cash or Deferred Profit Sharing Plan - 401(k)	Allow private-sector employees to defer salary to avoid current taxation and delay taxation of earnings.	Private-sector only. Employer-sponsored. Employer and employee contributions allowed.	Total contributions may not exceed 20% or \$30,000 gross annual income. Employee deferrals limited to \$9,500, and are fully vested.	Service requirements may be imposed for eligibility and vesting up to 7 years. Employer generally needs at least 10 employees for program to succeed. (State or local government may not adopt this type of plan unless set up prior to 1986)*
Keogh	Retirement savings incentive for self-employed and noncorporate employees.	Self-employed. Noncorporate companies and their employees.	Limited to lesser of 15% to 25% (depending on plan) or \$30,000 annually of includable compensation.	Similar to Profit Sharing and Money Purchase plans.
SEP (Simplified Employee Pensions)-IRA	Give small employers opportunity to shelter income from taxation and provide employer and employee with retirement income.	Employer-sponsored. For small private-sector employers and their employees.	Employer may contribute up to the lesser of 15% of compensation annually or \$30,000. Employee salary deferrals up to \$9,500 per year, but reduces amount employer may contribute to stay under overall cap.	Each employee must set up an IRA to which the employer may then contribute. Amounts contributed to another qualified plan count toward limits.

* Employee Benefit Research Institute, *Pension Funding & Taxation*, Washington, D.C., 1994, p. 51.

FIGURE 2

Comparison of Plans by Type (Continued)

PLAN TYPE	OBJECTIVE	WHO MAY PARTICIPATE	CONTRIBUTION LIMITS	SPECIAL CONSTRAINTS
Profit Sharing Plan	Provide a means for employees to share in employer profits, gain supplemental retirement income.	Employer-sponsored, but does not have to be tied to employer profits.	Employer contributions capped at 15% of employees' eligible compensation, but no more than \$30,000 annually.	Service requirements may be imposed for eligibility and vesting up to 7 years.
Individual plans				
Individual Retirement Account (IRA)	Shelter income from taxation, accumulate for retirement, defer taxation until distribution.	Any individual with earned income.	Individual may contribute up to \$2,000 annually plus \$250 for a non-working spouse.	Deductibility is limited if individual or spouse has an employer-sponsored pension plan.
Public nonprofit plans				
403(b) Plan	Provide tax-deferred annuities for nonprofit organizations and schools.	Employer-sponsored for employees. Both employers and employees may contribute.	Total contributions generally limited to 20% of eligible income. Employee may not contribute more than \$9,500 annually.	Additional elective contributions subject to special non-discrimination rules.
457 Plan (Not regulated under IRC as a pension plan, but is subject to some non-discrimination regulations.)	Allow for tax-deferred compensation for public employees similar to the 401(k) plan in private sector.	Only for employees of state and local governments.	Tax-deferred contributions limited to the lesser of 33.3% or \$7,500 of includable income.	Amounts deferred under a 403(b) plan must be taken into consideration when determining contribution limits.

*Primary Sources: D.A. Davidson & Co., "Retirement Plans", presentation booklet presented to CPERS, 1996; Employee Benefits Research Institute, *Pension Funding & Taxation*, 1994.

Summary

The University System's ORP is a primary 401(a) plan, a DC plan for higher education institutions. Montana's other public retirement plans are employer-sponsored DB plans and are the primary retirement plans for the vast majority of Montana's public employees.

Like many employees in medium and large private companies, Montana's public employees may also participate in voluntary DC plans to supplement their retirement savings. Montana law allows state and local employees to join a 457 deferred compensation plan, if the employer has provided for the plan.* School districts and universities may establish 403(b) plans for their employees, and many Montana school districts and the University System have done so. However, if the person belongs to a 457 plan, any amount contributed to the 403(b) plan is subject to the 457 tax-deferred contribution limitations.

An individual public employee may establish an IRA. However, because a public employee belongs to an employer-sponsored pension plan, contributions to the IRA would not be tax-deductible. Therefore, an IRA is not a practical retirement savings vehicle for public employees.

Social security also provides most of Montana's public employees with a certain amount of retirement income.**

In the final analysis, to achieve the recommended 80% income replacement in retirement Montana's public employees rely on their primary employer-sponsored retirement plans and may participate in secondary DC plans to supplement their retirement savings.

The next chapter discusses in greater detail each of Montana's primary DB retirement plans and the University System's DC retirement plan (the ORP).

*See Title 19, Ch. 50, MCA.

**Members of the statewide retirement plans for the Police, Firefighters, and Highway Patrol Officers are not covered by Social Security. See Chapter 3, Table 3.

CHAPTER 3

OVERVIEW OF MONTANA'S SYSTEMS

Montana law (Title 19 of the MCA) provides for the following public employee retirement systems:

- **Public Employees' Retirement System (PERS)** - a hybrid DB/money purchase (DC) plan covering the general classified positions in state and participating local governments;
- **Teachers' Retirement System (TRS)** - a DB plan covering teachers and certain administrative staff employed by the state, school districts, and the University System;
- **Sheriffs' Retirement System (SRS)** - a DB plan covering sheriffs and sheriffs' deputies employed by each county and certain investigators employed by the Montana Department of Justice;
- **Municipal Police Officers' Retirement System (MPORS)** - a DB plan covering police officers employed by participating cities, towns, and municipalities;
- **Firefighters' Unified Retirement System (FURS)** - a DB plan covering city firefighters employed by participating cities, towns, and municipalities;
- **Highway Patrol Officers' Retirement System (HPORS)**- a DB plan covering highway patrol officers employed by the state;
- **Game Wardens' and Peace Officers' Retirement System (GWPORS)** - a DB plan originally covering only Game Wardens employed by the state (i.e., the Game Warden's Retirement System or GWRS). This system will be expanded effective July 1, 1999, to include specified state law enforcement positions, including campus security officers.

- **Judges' Retirement System (JRS)**- a DB plan covering District and Supreme Court Justices and one Chief Water Judge employed by the Judicial Branch;
- **Volunteer Firefighters' Compensation Act (VFCA)** pension trust fund - a DB plan covering the volunteer (uncompensated) firefighters of qualifying volunteer fire companies organized in unincorporated areas; and
- **University System's Optional Retirement Program (ORP)** - a 401(a) DC plan covering the faculty and certain administrative staff of the Montana University System.

A summary of each plan's major benefit features, funding, and membership data is provided in Tables 1 through 8 at the end of this chapter.

Montana's public employee retirement systems, except for the University System's ORP and the VFCA, are pay-related cost-sharing DB plans that provide benefits based on the following formula:

$$X\% \text{ (or } 1/x) \times \text{ yrs of service} \times \text{ final avg salary (or final avg compensation)}$$

PERS is a Hybrid Plan

The PERS, which is the state's largest public pension plan, is not a pure DB plan; it is a hybrid plan. The PERS provides members who retire with the greater of the defined benefit based on the formula shown above, or the benefit provided by a "money purchase option". The following is the money purchase DC calculation:

the actuarial equivalent of double (100% employer match) of the member's accumulated contributions, annitized over the expected life of the member with an 8% interest rate

Administration

Public Employees' Retirement Board: As previously noted, the Public Employees' Retirement Board administers eight of the 10 statewide retirement plans: PERS, SRS, MPORS, FURS, HPORS, GWRS, JRS, and the VFCA.

The Board consists of six members appointed by the Governor as specified in Section 2-15-1009, Montana Code Annotated (MCA). The Board must include 3 active members of a public employee retirement system, a retired member of one of the plans, and two members selected at large. Each Board member serves 5 years. Until June 30, 1997, the Department of Administration hires and fixes the compensation of the Administrator and the staff necessary to support the Board. Under changes made by the 1997 Legislature, the Board will assume direct control of staff effective July 1, 1997.*

The Board members are fiduciaries of the Board-administered retirement systems and are constitutionally responsible for administering the systems in an actuarially sound manner and for conducting actuarial valuations of each plan.** The Board contracts for actuarial services. The Board's basic responsibilities and powers are set forth in Section 19-2-403, MCA.

Teachers' Retirement Board: The Teachers' Retirement Board administers the TRS. The TRS Board also consists of six members appointed by the Governor and must include three members from the teaching profession (one must be an active classroom teacher), two members who represent the public, and one member who retired from TRS.***

The TRS Board hires its own staff, including an Executive Director. The TRS Board members are fiduciaries for the TRS. Board powers and responsibilities are set forth in Title 19, Chapter 20, Part 2.

* See section 19-2-404, MCA, as amended by the 1997 Legislature.

** Art. VIII, Sec. 15, Mont. Const.

*** Section 2-15-1010, MCA, as amended. The 1997 Legislature removed the Superintendent of Public Instruction as an ex officio member and also required that one of the TRS members be actively teaching in the classroom.

Board of Regents: The Board of Regents contracts with an investment company (currently TIAA-CREF) for the administration of the University System's ORP. The Board's ORP-related duties and responsibilities are defined in Section 19-21-103, MCA. The ORP is not a mandated program. Section 19-21-101, MCA, simply authorizes the Board of Regents to establish an ORP for certain faculty and administrative staff members.

The University System employs members of TRS, PERS, the ORP, and, effective July 1, 1997, the GWPORS.

The Legislature: The Legislature remains the final authority for determining retirement policy and for setting contribution rates in all of the retirement systems.

1997 Legislative Changes

Legislation passed by the 1997 Legislature tended to equalize benefits within and among the public safety retirement systems. Additionally, the Legislature passed HB 170, a significant piece of legislation that provided retirees of the eight Public Employees' Retirement Board-administered plans with a 1.5% Guaranteed Annual Benefit Adjustment (GABA) after 3 years of retirement. The bill also provided full funding (including reduced benefits for new judges) for the JRS, which had been seriously underfunded.

Tables 1 through 7 on the following pages provide an abbreviated "at-a-glance" view of each of Montana's DB retirement plans. Table 8 summarizes the VFCA (a defined benefit plan funded only with state contributions). Table 9 summarizes the ORP. The 1997 legislative changes are shown by strikes, with the new provisions added in bold.

TABLE 1

RETIREMENT ELIGIBILITY AND BASIC BENEFIT FORMULA

(As of July 1, 1996)

	PERS	TRS	SHERIFFS' (SRS)	MUNICIPAL POLICE (MPORS)	FIREFIGHTERS' UNIFIED (FURS)	HIGHWAY PATROL (HPORS)	GAME WARDENS' (GWRS)	JUDGES' (JRS)
Minimum service and age required for the normal (unreduced) retirement benefit	30 yrs service, any age or 5 yrs srvc and age 60 or age 65	25 yrs service, any age or 5 yrs srvc and age 60	20 yrs service, any age	20 yrs service, any age	20 yrs service, any age, or 10 yrs service and age 50	Pre-7/1/85 hires: 20 yrs service, any age Post-7/1/85 hires: 20 yrs service and age 50	20 yrs service and age 50 or 10 yrs and age 50	5 yrs service and age 65
Minimum service requirement before being vested	5 years	5 years	15 years 5 years	10 years 5 years	10 years 5 years	5 years	10 years 5 years	5 years
Provides for voluntary, actuarially reduced early retirement benefit	Yes Earliest: age 50	Yes Earliest: age 50	Yes Earliest: age 50	No	No	Yes any age	No	No
Basic service retirement benefit formula	1.786% x FAS ¹ x years of service	1.667% x FAS x years of service	2.0634% ² x FAS x years of service	2.5% x FAC ³ x years of service	2.5% x FAC x yrs of service	2.5% x FAS x years of service	2% x FAS x years of service	Post 1/7/97 hires and covered by GABA 3.33% x GS ⁴ FAS x years of service to 15 + 1.785% x GS FAS x years of service over 15 Paid as 1
Paid out as:	Paid as 1	Paid as 1	Paid as 1	Paid as 2	Pre-7/1/81 hires not yet retired or retired and covered by GABA 2.5% x LMC ³ FAC x yrs of service to 20 + 2% x LMC 2.5% x FAC x yrs of service over 20 Post-7/1/81 hires 2% 2.5% x FAC x years of service Paid as 2	Paid as 2	Paid as 1	
1 = single life annuity; can be reduced to pay over more than one life								
OR								
2 = joint-life annuity to member and spouse (or dependent children)								

¹ FAS = final average salary = average salary of the 3 highest consecutive years of service.² FAC = final average compensation = average salary over the last 36 consecutive months of service.³ LMC = last monthly compensation = monthly salary last received by member.⁴ CS = current salary = current salary paid to the position from which the member retired.

Source: Public Employees' Retirement Board, Teachers' Retirement Board, and Actuarial Reports

TABLE 2
DISABILITY AND DEATH BENEFITS
(As of July 1, 1996)

	PERS	TRS	SHERIFFS'	MUNICIPAL POLICE	FIREFIGHTERS' UNIFIED	HIGHWAY PATROL	GAME WARDENS'	JUDGES'
Disability benefits Paid out as: 1 = single life annuity; can be reduced to pay over more than one life OR 2 = joint-life annuity to member and spouse (or dependent children)	1.766% x FAS' x years of service; no separate duty- related disability benefit; must have 5 years of service Paid as 1	1.667% x FAS x years of service or 25% of FAS; no separate duty- related disability benefit; must have 5 years of service Paid as 1	Service: 50% of FAS Non-service: Actuarially reduced from normal retirement benefit Paid as 1	Service or non- service: 50% of FAS Paid as 2	Service or non- service: Pre-7/1/81 hires: 50% of LMC; FAC for 20 yrs and 2% LMG FAC for each year over 20 Post-7/1/81 hires: ½ LMG plus 2% FMG for each year over 25 Paid as 2	Service: 50% of FAS Non-service: Actuarially reduced from normal retirement benefit Paid as 2	Service: 50% of FAS Non-service: Actuarially reduced from normal retirement benefit Paid as 1	New hires and covered by GABA: Actuarially reduced normal retirement benefit or ½ ES; FAS if duty- related Paid as 1
Basic death (survivorship) benefit paid to beneficiaries of active members Paid out as: 1 = single life annuity; can be reduced to pay over more than one life OR 2 = joint-life annuity to member and spouse (or dependent children)	Lump Sum: 1/12th of last 12 months compensation x (yrs of service or 6, whichever is less) plus member's accrued contributions plus interest; or Monthly Benefit: actuarial equivalent of early retirement benefit. Paid to designated beneficiary Paid as 1	Lump Sum: member's contributions plus interest; or Monthly Benefit: 1.667% x FAS x years of service Paid to designated beneficiary Paid as 1	Service: 50% of FAS Non-service: Actuarially reduced from normal retirement benefit Paid to designated beneficiary Paid as 1	Service or non- service: 50% of FAS Paid to surviving spouse or dependent children Paid as 2	Service or non- service: Pre-7/1/81 hires: ½ of LMG + 2% per year over 20- year-over-20- year-over-25 Post-7/1/81 hires: 50% of FAS Paid to surviving spouse or dependent children Paid as 2	Service: 50% of FAS Non-service: Actuarially reduced monthly retirement benefit Paid to surviving spouse or dependent children Paid as 2	Service: 50% of FAS Non-service: Actuarially reduced monthly retirement benefit Paid to designated beneficiary Paid as 1	New hires and covered by GABA: unpaid balance of retiree's benefit Post 1/7/97 hires and not covered by GABA: Actuarial equivalent of involuntary retirement benefit; or if duty related, the actuarial equivalent of the service retirement benefit. Paid to designated beneficiary Paid as 1

Source: Public Employees' Retirement Board, Teachers' Retirement Board, and Actuarial Reports

¹ FAS = final average salary = average salary of the 3 highest consecutive years of service.
² FAC = final average compensation = average salary over the last 36 consecutive months of service.
³ LMC = final monthly compensation = monthly salary last received by member.
⁴ CS = current salary = current salary paid to the position from which the member retired.
⁵ Based on the system's basic service retirement formula.

TABLE 3
AVERAGE RETIREE PROFILES
(As of July 1, 1996)

	PERS	TRS	SHERIFFS'	MUNICIPAL POLICE	FIREFIGHTERS' UNIFIED	HIGHWAY PATROL	GAME WARDENS'	JUDGES'
Average retirement age	60 years	56 years	55 years	47 years	49 years	50 years	56 years	67 years
Average years of service at retirement	18.5 years	26 years	18 years	19 years	22 years	23.5 years	27 years	16 years
Number of Benefit Recipients	12,344	7,898	142	507	435	238	75	47
Average monthly benefit (All recipients)	\$537/month	\$922/month	\$802/month	\$1,156/month	\$1,124/month	\$1,213/month	\$1,222/month	\$2,130/month
Average initial benefit (as a percent of salary at retirement)	33%	43.33%	37.5%	47.5%	54%	59%	54%	51.8%
Social security coverage	Yes	Yes	Yes	No	No	No	Yes	Yes

Source: Public Employees' Retirement Board, Teachers' Retirement Board, and Actuarial Reports

TABLE 4

ACTUARIAL FUNDING REQUIREMENTS
(As of July 1, 1996)

NOTE: Changes shown indicate best estimate. Funding requirements will change, but final numbers will not be available until next valuation in 1998.

	PERS	TRS	SHERIFFS'	MUNICIPAL POLICE	FIREFIGHTERS' UNIFIED	HIGHWAY PATROL	GAME WARDENS'	JUDGES'
Total active members ¹	27,895	18,695	582	527	418	211	92	44
Number of Benefit Recipients	12,344	7,898	142	507	435	236	75	47
Number of vested but inactive members	1,391	1,012	22	6	4	4	1	1
Total actuarial cost as a percentage of salary	13.4%	14.514%	16.4%	40.46% ²	46.37% ²	45.28% ²	16.05%	48.01% ³
Percentage of salary required to fund accruing benefits, i.e., normal cost	10.3%	9.328%	15.23%	22.65%	19.17%	25.88%	15.58%	41.03%
Percentage of salary used to amortize existing unfunded liabilities	3-1% 3.3%	5.186%	0	17.83%	27.2%	19.40%	0%	6.98%
Unfunded liability (or past service debt)	-\$196,500;357 increased	\$562,900,000	\$0 slight increase	\$35,595,827 slight increase	\$63,365,516 slight increase	\$20,383,689 slight increase	\$0- slight increase	\$2,779,065 \$0
Years required to amortize current unfunded liabilities	10-94 26 yrs	27.2 years	0 1.35 yrs	14-41 17.7 years	20-98 22 years	20-4 20.63 years	0 2.8 years	15-82 0 years

¹ Active members are employees currently working and contributing to the system.

² Does not include special funding used to pay supplemental or minimum benefits.

³ Actual contributions to the JRS WAS less than the 48.01% required. By law, 34.71% WAS to be contributed from District Court fees. However, actual contributions from District Court fees (as shown on Table 5) WERE less than 20%, which WAS 14.75% short of required funding.

Source: Public Employees' Retirement Board, Teachers' Retirement Board, and Actuarial Reports

* Most of the changes on this table result from enactment of HB 170, which provides a Guaranteed Annual Benefit Adjustment (see Table 8).

TABLE 5

FY1996 ACTUAL EXPENDITURES
(As of July 1, 1996)

Note: Figures shown in bold represent changes made by 1997 Legislature, although ACTUAL expenditures will not be valued until 1998.

	PERS	TRS	SHERIFFS'	MUNICIPAL POLICE	FIREFIGHTERS' UNIFIED	HIGHWAY PATROL	GAME WARDENS'	JUDGES'
Total annual payroll covered	\$608,592,099	\$501,000,000	\$17,889,806	\$15,827,596	\$13,782,660	\$6,241,716	\$2,761,752	\$2,906,601
Employer contribution	6.7% 1/7/97 = 6.8% 1/7/99 = 6.9%	7.47%	8.535% 9.535%	14.36% 14.41%	14.36%	36.28% 36.33%	8.15% 9.0%	6.0% 38.19% ¹
Employee contribution	6.7% 1/7/97 = 6.8% 1/7/99 = 6.9%	7.044%	7.865% 9.245%	7.8 / 9 / 10.5% depending on hire date Post-1/7/97 hires or current members electing GABA: 11%	7.8% 9.5% Post-1/7/97 hires or current members electing GABA: 11%	9.0% 9.05%	7.90% 8.50%	7.0%
Additional funding from other sources as a percentage of payroll	None State contribution for local govt. employers (to fund GABA): 0.1%	None	None	Insurance premium taxes: 15.66% (for basic benefits) 12% (for supplemental benefits) 29.02% (now actuarially funded)	Fire insurance premium taxes: 24.21% 32.24% (for actuarially funded benefits) 7.7% (for additional supplemental benefits)	Vehicle registration fees: 4.3% (for lump-sum supplemental benefits)	None	District Court fees: 20% ¹ Supreme Court fees: -3% All court fees now go to GF
Percentage of payroll used to fund normal costs	10.3% 10.5%	9.328%	15.23%	22.65%	19.17%	25.86%	15.58%	-33.3% 38.19%
Percentage of payroll to unfunded liabilities	3.1% 3.3%	5.186%	0%	17.83%	27.2%	19.4%	0%	0
Total actual FY 96 expenditures as a percentage of total payroll (all funding sources)	13.4%	17.93 %	16.4%	52.52%	54.07%	49.58%	16.05%	33.3 %

¹ This amount is now sufficient to fund normal costs of benefits. JRS now has no unfunded liabilities. Amount of this increase must be offset by the amount of the court fees that are now being deposited (about 33.3%) into the General Fund instead of into JRS.

TABLE 6
VOLUNTEER FIREFIGHTERS' COMPENSATION ACT
(As of July 1, 1996)

PENSION PLAN FEATURES	VOLUNTEER FIREFIGHTERS' PENSION FUND
Minimum service and age for normal (unreduced) retirement	20 years of service and age 55
Vested	After 10 years of service
Basic benefit formula	\$100 per month for 20 years of service (prorated for 10 years through 19 years of service)
Disability	If injured in line of duty, fund pays for necessary and reasonable medical expenses, not to exceed \$25,000 within 36 months of injury
Death benefit	Actual funeral expenses (only if killed in the line of duty), not to exceed \$1,500, are paid to funeral provider; member's entitlement, not to exceed a total of \$4,000, is paid to surviving spouse or children until spouse remarries or children reach 18 years of age
Membership	722 retirees; 2 survivors
Contributions	Funded entirely by insurance premium taxes (\$862,010 in FY 96) and investment income (\$894,584 in FY 96)
FY 1996 monthly benefit	\$100 per month for 20 years of service, prorated for 10 -19 years of service. Average FY 96 benefit = \$85/month
Total benefits paid in FY 1996	\$737,099

UNIVERSITY SYSTEM OPTIONAL RETIREMENT PLAN

(As of July 1, 1996)

PLAN FEATURES	UNIVERSITY SYSTEM OPTIONAL RETIREMENT PLAN		
Retirement eligibility	A member may retire at any age when service is terminated and under policy guidelines established in the plan. "Normal retirement" is defined as the last day of the academic year in which the member attains age 65.		
Benefit	An account the provides a lump-sum benefit that may be reinvested or converted to different types of annuities depending on plan policy. Amount in the account depends on total contributions plus investment earnings.		
Disability benefits	None, except for the member's annuity income, which can begin at any time.		
Death and survivor benefits	The full current value in a member's annuity account is payable to the beneficiary before retirement. The benefit can be paid in a single sum, as an annuity income to the beneficiary for life, or as an annuity income for a fixed period of years. The annuity may also be deferred as federal law permits.		
Social security coverage	Yes.		
Total active members	1,115		
Total payroll covered	\$31,475,709		
Employer contribution as a percentage of payroll	4.596% (Board of Regents authorized to change to 6.00% on 7/1/97)		
Employee contribution as a percentage of salary	7.044% (Board of Regents authorized to change to 6.00% on 7/1/97)		
University System's contribution to TRS for U-system's portion of unfunded liability	2.503%	2.82% on 7/1/97 3.12% on 7/1/98 3.42% on 7/1/99	3.73% on 7/1/00 4.04% on 7/1/01
Years to amortize University System's portion of TRS unfunded liability	36 years		
Total contributions	14.503%	14.82% on 7/1/97 15.12% on 7/1/97 15.42% on 7/1/97	15.73% on 7/1/00 16.04% on 7/1/01

TABLE 8

**POSTRETIREMENT ADJUSTMENTS TO
MONTANA'S PUBLIC RETIREMENT SYSTEMS**

METHOD GIVEN	SYSTEM(S) COVERED	AVERAGE INCREASE PAID 1/1/96
HB 170: Guaranteed Annual Benefit Adjustment (GABA) on Jan. 1 following 36 mos from retirement date	All except for: TRS VFCA ORP	Effective 7/1/97: members retired for at least 36 mos. will begin receiving 1.5% increase on Jan. 1 following retirement anniversary date.
1) Retirees are paid an additional monthly retirement adjustment based on the system's investment earnings. Retirees are paid a portion of the investment earnings above 8% realized gain, which is the average yield assumed by the actuary.	PERS repealed TRS Sheriffs' repealed Game Wardens' repealed	\$0/month (0%) \$0/month (0%) \$0/month (0%) \$0/month (0%)
(2) Retirees are paid a minimum benefit that is equal to ½ the salary of a newly confirmed member. This adjustment is funded by annual payments from the state's insurance premium tax fund.	Municipal Police Officers' Firefighters' Unified (only pre-7/1/97 members who do not elect GABA)	Maximum benefit varies by city and individual retiree Average increases for those eligible and receiving the supplements in FY 95 averaged: Police: 2.62%/yr Fire: 3.08%
(3) Retirees are paid a minimum benefit by changing the basic formula to reflect the current salary of a probationary patrol officer. Also, pre-7/1/91 retirees receive an annual lump-sum supplement funded by an additional 25-cent vehicle registration fee.	Highway Patrol Officers' (only pre-7/1/97 members who do not elect GABA)	Minimum benefit varies by individual retiree; avg. benefit grew at rate of 3.82% per year in FY 96. Average lump sum supplemental benefit for pre-7/1/91 retirees in FY 96 was \$1,917.
(4) Retiree benefit allowances are increased based on the current salary paid to the office from which the member retired.	Judges' (only pre-7/1/97 members)	Received an average increase of 2.4%/year in 1996

CHAPTER 4

COMPARING THE PLANS

The following is a discussion of DB retirement system components and an assessment of each of Montana's systems in context with national trends and compared with Montana's other public retirement systems. Also, several points are noted about the information provided in Tables 1 through 8 included in Chapter 3.

Benefit Formula Multipliers

As previously mentioned, for Montana's DB plans, the basic pension benefit formula used to calculate a member's benefit is expressed as:

$$\text{"X"% (or } 1/X) \times \text{final avg. salary} \times \text{years of service}$$

The percentage (or fraction) used in the benefit formula is sometimes referred to as the "escalator" or "multiplier". The multiplier used is different in each plan. (See Table 1 in Chapter 3).

PERS benefit multiplier: Most general employee public DB plans nationwide have a formula multiplier of 1.9% to 2.1%. The next most frequent range of multipliers is 1.5% to 1.7%.^{*} Thus, Montana's PERS benefit formula multiplier (1.786%) is slightly lower than the most frequent range of multipliers, but slightly above the second most frequent range.

TRS benefit formula: Data collected by the National Education Association (NEA) shows that the most frequent multiplier among the 100 large pension plans that the NEA surveyed was 2.0% or higher. The next most frequent range of multipliers was 1.5% to 1.74%.

^{*} Wisconsin Retirement Research Committee, *1996 Comparative Study of Major Public Employee Retirement System*, by Blair Testin, December 1996.

Montana's TRS benefit formula (1.667%) is lower than the most frequent range, but in the middle of the second most frequent range of multipliers.*

Public safety benefits higher: Retirement benefits for public safety personnel are generally higher in most states than for general employees, as shown by a 1991 NCSL survey. The NCSL report offers several potential reasons for the higher benefits: (1) the benefits provide compensation for the higher risk in public safety professions; (2) public safety professionals tend to have shorter lives and are entitled to the actuarially determined higher benefit; and (3) public safety positions are often not covered by social security.** In Montana, positions covered by MPORS, FURS, or HPORS are not covered by social security. The 1997 Legislature equalized the multipliers among the police officers', firefighters', sheriffs', and highway patrol officers' plans by raising the sheriffs' and firefighters' multipliers to 2.5%. The GWRS multiplier, however, remains 2%. (See Table 1 in Chapter 3)

Final Average Salary

The vast majority of public pension plans nationwide determine final average salary (FAS) based on the average of the highest salary over 3 consecutive years of salary. Montana's plans are generally consistent with this practice. The 1997 Legislature made use of FAS more consistent across Montana's systems. In two systems (FURS and MPORS), final average compensation (FAC) is used. By definition, FAC is not the average of a member's highest 3 years of salary, but the average of the member's last three years of salary. For members of FURS and MPORS, it usually works out that a member's final three years of salary are the member's highest three years of salary. So, there is little practical difference.

*National Education Association, *Characteristics of 100 Large Public Pension Plans With Special Emphasis on Plans Covering Education Employees*, Research Division, August 1996, pp. 31-38.

**Susan Ross, "Comparative Retirement Benefits for General State Employees and Public Safety Personnel," *State Legislative Report*, Vol 15, No. 5, July 1991, National Conference for State Legislatures.

The NCSL Public Pension Working Group cautions that legislatures should be wary of salary "spiking" where, in order to enhance a retirement benefit, an employee's salary is inflated just prior to the employee's retirement. In fact, to account for additional costs associated with salary "spiking", actuaries for Montana's TRS add a "load factor" when making salary assumptions for employees of the University System. This is because of the University System's history of providing their employees with higher final salaries for retirement purposes.*

Years of Service and Retirement Age

The years of service and age requirements for normal retirement eligibility affect how many years contributions can be made into the plan and how long the benefits will be paid after retirement. Historically, the purpose of a retirement plan was to provide financial security after the employee's working career was over, i.e., when the employee could no longer work. Thus, typical retirement age was about 65 years and the employee worked for about 40 years. It was reasonable to fund any unfunded liabilities over the working career of an employee, i.e., 40 years. As the concept that one should retire while still able to "enjoy" retirement emerged, the typical retirement age fell to 60 years of age or less. Working careers were reduced from 40 years to 30 years.

According to a 1996 comparative study by the Wisconsin Retirement Research Committee, the public sector norm for retirement eligibility without a reduced benefit ranges from a high of age 65 to a low of age 50, with various combinations of years of service and age requirements. A trend toward reducing the retirement age eligibility criteria has slowed and seems to be stabilizing at age 60.**

*Montana Teachers Retirement System. See also May 28, 1997, letter to TRS from Milliman & Robertson, Inc., Actuaries & Consultants.

**Wisconsin Retirement Research Committee, *A Comparative Study*, 1996, pp. 5-6.

Many public defined benefit plans are adopting "X years and out" provisions, which allow members to receive full benefits at any age if the member has served a certain number of years. In Montana, three of the five public safety retirement plans provide for normal retirement after 20 years regardless of age (SRS, MPORS, and FURS). In HPORS and GWPORS, a member must also reach age 50. (See Table 1 in Chapter 3.)

In public safety professions, there is an occupational incentive to leave the profession when age and "burn out" begin to affect job performance. Thus, the typical working career of most public safety officers is about 20 years.

For general public employees, the vast majority of public pension plans surveyed by the Wisconsin committee require a member to work at least 30 years to retire at any age or to be at least 55 years old in order to be eligible for a normal service retirement.*

One policy consideration is that reducing the years of service and age required for retirement eligibility in a DB plan results in less time to contribute to a retirement plan, less time to responsibly amortize a debt (which is based on the length of working careers), and a longer time to pay out the benefit. The result is more cost. Significant additional cost was incurred in TRS when the 1983 Legislature reduced normal retirement from 30 years to 25 years of service.

Vesting

A member becomes "vested" (i.e., eligible to receive retirement benefits) when the member has contributed to the system for a certain number of years. According to the Wisconsin survey, there is a slow trend toward reducing the number of years of service required for vesting. A majority (55%) of public employee DB systems require five or less years of service to vest, which is consistent with federal vesting requirements that apply to private-sector pension

* Wisconsin Retirement Research Committee, *A Comparative Study*, 1996, pp. 5-6.

plans. Nevertheless, the 1996 Wisconsin study points out that public pension plans remain more conservative than the private sector plans; nearly 40% of the public plans surveyed still require 10 years or more of service for a member to vest.

The 1997 Legislature established 5-year vesting in all of Montana's public retirement plans. This change was not anticipated to significantly affect actuarial funding within the affected plans. (See Table 1 in Chapter 3.)

Early Retirement

Early retirement provisions allow members to draw a monthly retirement benefit earlier than otherwise required under normal eligibility requirements. Usually, the benefit provided is reduced according to actuarial calculations from what the benefit would have been had the member reached retirement age or completed the requisite years of service. The Wisconsin study shows that 90% of surveyed general public plans allow early retirement. The most commonly used eligibility requirement for early retirement is age 55. A close relationship exists between early retirement eligibility and vesting. Vesting requirements establish the minimum number of years of service required before a member is eligible for a retirement benefit, which normally commences when the member has reached the normal or early retirement age. (See Table 1 in Chapter 3.)

In Montana's PERS, TRS, and SRS, voluntary early retirement with an actuarially reduced benefit is allowed at age 50. In the HPORS, early retirement is allowed at any age, but the benefit amount is significantly reduced if paid prior to age 50.

Early Retirement Incentive Programs

Recently, many governmental units, seeking cost savings and a reduction in the work force, have offered early retirement incentives that pay an enhanced retirement benefit if a public employee retires early within a certain time frame or

window of eligibility. Theoretically, money is saved by reducing government payrolls, i.e., senior, higher-paid employees will retire and their positions will either remain vacant or be eventually filled by new employees who are paid lesser salaries. However, there are "hidden" costs for training and lost productivity.

The 1993 Montana Legislature enacted an early retirement incentive in which participating employers purchased up to 3 years of additional service credit for state and local employees who were already eligible for early retirement or normal service. The 1995 Legislature renewed the early retirement incentive by providing another window of eligibility for certain members of the Office of Public Instruction.

According to a September 1995, Department of Administration report evaluating the results of the 1993 incentive, of the 2,206 employees eligible for the incentive, 645 took advantage of it, which was 398 more employees than were expected to retire anyway. The report shows FY 94 costs of about \$15.7 million and an FY 95 savings of about \$12.5 million. The report cautions the legislature against using the retirement system to provide termination incentives designed to save money.

Postretirement Benefit Increases

The 1997 Legislature enacted a 1.5% GABA for retirees in all systems except for the TRS, VFCA, and ORP.* Postretirement provisions were summarized in Table 8 in Chapter 3. Under TRS, retirees receive an annual postretirement increase that is calculated as an annuity paid from realized investment returns over the assumed 8%. (See Chapter 5 for a discussion of investments and returns.)

* As a money purchase, DC plan, the ORP cannot provide for a postretirement benefit increase.

For retirees in the covered systems, the GABA will provide for a prefunded, automatic postretirement increase of 1.5% annually. This moves Montana away from the significant cost of *ad hoc* adjustments. Nevertheless, when retirees feel that the 1.5% adjustment is not adequate, they will likely approach future legislatures with proposals to increase the percentage of the annual adjustment.

Summary

This chapter has discussed some of the major components of each of Montana's eight DB cost-sharing plans and compared the plans with national survey data about other public plans.

One consistent theme raised during legislative sessions is whether Montana's public safety plans should be consolidated. Although consolidation was once studied in the 1970's and found to be unfeasible because of sharp differences and cost, incremental changes have tended to equalize the benefits among these public safety plans. Therefore, consolidation may be an issue for further consideration. The CPERS has the statutory obligation to review each plan's benefit structure and assess the equity and adequacy of the benefits provided.

CHAPTER 5

ASSESSING FISCAL HEALTH

This chapter discusses the fiscal health of Montana's public retirement systems. Many factors are involved in assessing plan funding; much more than are involved by simply comparing assets with liabilities, though that is the basic concern.

Assessing the fiscal health of a DB plan involves understanding that assets include both current and projected contributions plus investment earnings and that liabilities include past, present, and projected liabilities and expenses. In a DB plan, fiscal analysis requires actuarial valuations by certified actuaries.

Actuarial valuations are not required to determine the fiscal status of DC plans, such as the University System ORP, because DC plans do not have unfunded liabilities or rely on projections to estimate costs. The benefit paid under the ORP is equivalent to the members' accumulated contributions and realized investment return. What is at issue is the quality of investment options, the sufficiency of contributions, individual choices, and market performance.

Actuarial Valuations

As earlier summarized, an actuarial valuation is a mathematical investigation to determine the financial condition of a DB retirement system at a particular point in time and to project the system's future funding needs. There are several accepted actuarial methods, including the following: entry age normal, unit credit, aggregate cost, attained age, and projected benefit. A 1996 Wisconsin survey of 85 statewide public retirement plans covering general classified employees and teachers shows that 76% of the plans used the entry age normal method.* This is the method used by actuaries for Montana's DB plans. The goal is to provide level normal cost projections over the long-term.

*Wisconsin Retirement Research Committee, *1996 Comparative Study*, p. 21.

Entry age normal is an actuarial cost method whereby a level cost for each employee is established. The cost is considered to accrue annually from employment to termination. Thus, using actuarial assumptions, the normal cost of benefits as they accrue can be projected to ensure that each employee's defined benefit can be paid when the benefit is due.*

To help determine what contribution amount is sufficient to fund total costs, actuaries must make assumptions about rates of employment termination, retirement, mortality, disability, withdrawals, salary increases, investment returns, future market gains and losses, and administrative expenses. These assumptions and the mathematics used by actuaries are the backdrop behind the term "actuarial".

Each actuarial valuation determines the following fiscal information:

(1) *Current assets (or "actuarial" value of assets)*: the adjusted market value of the system's assets (i.e. holdings) with the actual realized investment gains and losses smoothed over a 3- or 4-year period.**

(2) *Normal cost contribution rate*: the percentage of each member's salary that is required to fund benefits as they are being earned (i.e. current benefits) by active members (i.e., working employees).

(3) *Future liabilities*: the present value of current benefits as they will accrue in the future for current members.

(4) *Total liabilities*: the present value of all past and future liabilities for all current active and retired members.

*Bleakney, *Retirement Systems for Public Employees*, pp. 86-87.

** This method is used by actuaries for Montana's public retirement systems. Other systems may use a different method.

(5) *Unfunded liabilities*: the portion of total liabilities that cannot be funded by current assets or anticipated future contributions and investment earnings (*total liabilities* minus *future liabilities* minus *current assets* = **unfunded liabilities**).

(6) *Amortization period of unfunded liabilities*: the period of time it will take to pay off current unfunded liabilities given available contributions.

(7) *Actuarial soundness*: a system is actuarially sound when contributions are sufficient to pay for the normal costs of benefits as they accrue and to make payments on the unfunded liability.

An actuarial valuation of each statewide public employee retirement system is conducted every 2 years through June 30 of the valuation cycle. The Public Employees' and Teachers' Retirement Boards contract with actuarial firms to provide actuarial valuations.

Actuarial soundness: Montana's Constitution (Art. VIII, Sec. 15) requires that the pension funds be managed on an actuarially sound basis, yet the constitutional language provides no definition of "actuarially sound".

To help define actuarial soundness, the 1997 Legislature established in statute (through an amendment to HB 170) that each system administered under the Public Employees' Retirement Board must be funded on an "actuarially sound basis" and defined "actuarially sound basis" as meaning that system funding is sufficient to amortize unfunded liabilities in 30 years or less.

Actuarial gains and losses: Because an actuary's assumptions are crucial to the valuation and funding of DB plans, "experience studies" are conducted every 8 to 10 years. An experience study examines the actual history and experience of the system. Future assumptions can then be adjusted, if necessary, to keep assumptions consistent with the actual experience of the plan. Outside actuaries may also periodically audit the valuations.

Differences between assumed and actual experience results in actuarial gains and losses. In each of Montana's public retirement systems, gains or losses in FY 96 were within acceptable parameters. Again, more information on these gains or losses is available from each system's administrative board.

Indicators of Financial Strength

Each of Montana's retirement systems has been certified by an actuary as sound.* But, aside from this general certification, one way to examine fiscal health is to look at a system's accrued liabilities in terms of: (1) the percentage of each system's accrued actuarial liabilities (AAL) that are funded by the actuarial value of assets (the higher the percentage the stronger the system's funding); and (2) the system's unfunded AAL (UAAL) as a percentage of the system's total covered payroll (the lower this percentage the stronger the system's funding).** The UAAL as a percentage of total payroll is not related to the percentage of payroll required to amortize unfunded liabilities. Historical data further detailed in system financial reports shows system trends and whether the system is getting weaker or stronger. In recent years, Montana's systems have, overall, been getting stronger.***

Figure 3 shows the funding status of each retirement system as of June 30, 1996.

* The JRS was not considered sound until the 1997 Legislature, as part of HB 170 (GABA), fixed the chronic underfunding of the plan and paid off mounting JRS unfunded liabilities.

** Until 1995, the Governmental Accounting Standards Board (GASB) required public pension plans report the "pension benefit obligation", which is a measure of the present value of pension benefits, adjusted for inflation (i.e., projected salary increases) but estimated on service earned only to date. The new GASB statement now requires reporting based on actuarial accrued liabilities.

*** According to the Public Employees' Retirement Board's FY 1996 fiscal report, expressing the UAAL as a percentage of a system's total covered payroll shows how the total dollar amount of the UAAL compares the total payroll of the system's active contributing members. This comparison over time helps show the effects of inflation.

FIGURE 3
ACTUARIAL ACCRUED LIABILITIES BY SYSTEM

System	Percentage of the system's AAL funded by present value of system assets	UAAL amount as percentage of covered payroll
PERS	89.24%	32.29%
TRS	71.0%	112.3%
SRS	130.13%	0.0%
MPORS	66.31%	224.90%
FURS	51.67%	459.75%
HPORS	69.90%	326.57%
GWRS	104.82%	0.0%
JRS ¹	89.98%	95.61%
VFCA	51.67%	not applicable

Source: Compiled from the financial reports of each system as of June 30, 1996, from the Public Employees' Retirement Board and the Teachers' Retirement Board.

1 - The percentages shown for JRS do not reflect the underfunding of JRS before it was addressed in HB 170 during the 1997 Legislative Session.

A recent article comparing retirement-plan funding nationwide (based the pension benefit obligation ratio) showed that:

- 19 states reported current actuarial assets amounting to 100% or more of the plan's projected benefit obligations;
- 16 other states had retirement plans funded at a level of between 80% to 99% of plan assets;
- 9 states had retirement plans funded at between 60% and 79% levels; and
- 5 states had retirement plans funded at levels of less than 60%.*

*Penelope Lemov, "Michigan's Big Pension Gamble," *Governing*, May 1997. Article cites Wilshire Associates, Inc. as source on retirement-plan funding levels.

Investment Assumptions and Performance

Investment return is the largest revenue source for Montana's public pension funds. Each retirement plan's trust fund is managed separately and invested by the Montana Board of Investments. Assessing funding in a DB retirement system assumptions about market performance compared to realized gains and realized gains compared to inflation, and all of this in the context of having the cash on hand to pay defined monthly benefits when due regardless of market swings.

Investment return assumption: Actuaries for both the Public Employees' Retirement Board and TRS have historically assumed an 8% average investment return. Actuaries for Montana's DB plans smooth market gains and losses over four years to keep capitol gains and losses in each year from showing wide swings in investment yield and so that actuarial projections can remain stable.

The 1996 Wisconsin comparative study showed that of the 85 public plans surveyed, 61 plans assume earnings of between 7% and 8%; 22 plans assume an 8% return or more.*

Investment performance: System financial reports and reports by the Board of Investments tend to highlight the growth in the value of investment holdings (i.e., the market value of assets), but do not tend to highlight the realized rate of return in each year. Nevertheless, a line graph presented in the FY 1996 annual report of the Board of Investments shows that for PERS, the realized rate of return was about 6% in 1972, climbed to a peak of about 12% in 1984, and has been falling every year since that time. In FY 1996, realized return was slightly less than 8%, while the realized rate of return over the last five years has averaged 8.16% per year.

Investment allocation: Total investment performance depends on asset allocation. The Board of Investments has slowly been shifting the allocation of pension fund

* Wisconsin Retirement Research Committee, *1996 Comparative Study*, p. 21.

investments from more assets in fixed-return investments, toward more assets in equities, which have a greater return potential (as well as a higher risk).^{*} In FY 1996, according to the Public Employees' Retirement Board 1996 annual financial report, asset allocation for PERS investments was 57% in fixed-income investments and 43% in equity investments, while allocation in each of the Board-administered smaller systems was 61% in fixed-return investments and 39% in equities.^{**} The TRS pension fund investments tend to track with and be managed in a similar manner as the PERS funds.

Investment categories: Montana's pension fund investments encompass four major types of asset classes:

- Short Term Investment Pool;
- Equities (including the Montana Common Stock Pool, Domestic Common Stock, International Common Stock, the MT Convertible Bond Pool, and Alternative Equities);
- Fixed-income investments (including the Retirement Funds Bond Pool or RFBP); and
- Miscellaneous investments (including Montana mortgages and equity real estate).

Details on investment holdings and earnings are available in retirement board annual fiscal reports and the Board of Investments' annual report. For PERS, the Board reports a composite investment return of 12.60% compared to a composite investment return of 13.47% for selected market indices.^{***} Again, these

^{*}Montana Board of Investments, *Fiscal Year 1996 Annual Report*, Montana Department of Commerce, 1996, p. 31.

^{**}Public Employees' Retirement Board, *Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1996*, Public Employees' Retirement Division, Montana Department of Administration, 1996.

^{***}*Ibid.*, p. 40.

percentages are not the “realized” rate of return, but do reflect how the value of investment holdings has grown compared to market indices.

So What?

After looking through the investment data and fiscal data on contributions and expenses, the question is what does this all mean?

A few key concepts may help: (1) realized gain is the actual gain, not the market gain so market value is not as important as the long-term gains, (2) the value of a plan’s assets should cover both normal costs as benefit accrue as well as pay off any past service liabilities that were not previously funded as the benefits were being earned, and (3) realized investment return on any given day is not as integral to plan funding as the spread between investment earning and salary inflation assumptions as the as those assumptions compare to actual experience. Each of these concepts is discussed in greater detail below.

Realized gains versus market gain: When assessing investments and investment return, a key concept to keep in mind is that “realized return” is not the same as the market value of investment holdings or a market gain. Realized return is the net gain (or loss) to system assets when an investment holding is sold. The amount realized depends on what the system paid to acquire the holding (the “book value” of the holding) and what the holding sold for at the market. To keep market swings from upsetting long-term projections about investment yield, actuaries value market returns by smoothing realized gains over several years (4 years for PERS).

Covering both the unfunded and funded liabilities: A DB plan’s total liabilities consist of both funded and unfunded liabilities. The “unfunded” portion of a system’s liabilities is the portion of the total liabilities that cannot be covered by the actuarial value of assets on the day of the valuation. To make up the difference, asset growth (contributions and the projected investment return on those contributions) must be sufficient to pay for both the normal cost of benefits

as they are being earned and the cost of the benefits that were not funded as they were being earned. A healthy DB plan as sufficient contributions so that normal costs are covered and there are enough contributions left over to make payments on past unfunded liabilities.

For example, as shown for PERS in Table 4 of Chapter 3), 13.4% of salaries is being contributed to fund PERS. The normal cost of covering benefits as they are being accrued is 10.4%. This leaves 3.1% of salaries that can be used to pay for system's unfunded liabilities. Given this 3.1%, and given the actuarial assumptions being used, the unfunded liabilities will be paid off in 10.94 years. Therefore, as long as the plan is funded so that normal cost and past liabilities are being covered by contributions and projected growth, then the system is being "prefunded" and the benefits can be fully paid when they come due.

Social security is often bemoaned as the prime example of a system that is not prefunded so that benefits can be paid when due. Because of various policy decisions that depleted principal (and therefore exponentially reduced investment earnings) and that added new benefits that were not prefunded, the social security system will reach a point in time when the benefits cannot be paid when they come due.

Economic spread: Another important concept is that investment performance and the value of assets must be considered in context with the system's inherent economic assumption about the spread between investment return and salary inflation. This "economic spread", which is the difference between the smoothed investment return assumption and the salary inflation assumption, becomes a key factor in assessing a retirement system's actual growth.

For example, the assumed compounded growth rate of salaries in 1996 for PERS was 6.25% per annum, while the smoothed investment return assumption was 8%.* Thus, the economic spread between assumptions is 1.75%. If the plan's

*Montana Public Employees' Retirement Board, *1996 Comprehensive Annual Financial Report*, pp. 50-51.

actual experience exceeds this assumed spread, the system will have actuarial gains. If actual experience results in a smoothed investment return and actual salary inflation that is below 1.75%, the system will experience actuarial losses. However, actuarial gains and losses do not affect actual plan assets, but affect only the projected schedule for amortizing unfunded liabilities. This is why the amortization schedule may be referred to as a “shock absorber”. Montana’s PERS has historically amortized unfunded liabilities faster than the projected amortization schedule because of the system’s actuarial gains when assumptions have been more conservative than experience.

The Wisconsin survey shows that in 1996, the average spread between the investment earning assumption and the wage inflation assumption was 3.17%, compared to the average spread in 1992 of 2.85%.^{*} Thus, Montana’s 1.75% spread between assumptions is relatively more conservative than most of the surveyed plans.

The retirement boards, supported by experts (actuaries and investment managers), are responsible for ensuring the retirement plans remain healthy. Based on the above discussion, the investment return assumption being used may seem conservative given recent market performance, but is within the norm of a survey of other similar plans. Contributions to each of Montana’s DB plans are sufficient to cover both normal costs and pay off unfunded liabilities in less than 30 years (i.e., the systems are actuarially sound). Finally, the economic spread in PERS is conservative compared to other similar plans and because actual experience results in actuarial gains more often than losses, PERS unfunded liabilities are often paid off sooner than the projected amortization schedule.

^{*}Wisconsin Retirement Research Committee, *1996 Comparative Study*, pp. 21-22.

Investments and DC Plans

As has been noted throughout this guide, a DC plan provides a lump-sum benefit based solely on total accumulated contributions and investment performance. Thus, contribution amounts and the investment choices made by participants determines the benefit ultimately paid.

The ORP investments: The University System's ORP (optional retirement plan) is managed by TIAA-CREF* as guided by policy established by the Board of Regents. The ORP is a DC plan set up under section 401(a) of the IRC. Specific provisions of 401(a) plans differ according to state law and administrative policy. TIAA-CREF is a nationwide retirement system for people who work in higher education institutions and is the largest retirement system administrator in the world. The ORP managed by TIAA-CREF offers to each participant a menu of investment options within a few different categories of fund types. These options consist of one guaranteed income account (the TIAA Traditional Annuity Account) and eight variable accounts.

Figure 4 lists the eight basic variable accounts offered in the ORP by TIAA-CREF along with the 1-year, 5-year, and 10-year average annual compound rate of return for each account.

* TIAA-CREF stands for the Teachers Insurance and Annuity Association-College Retirement Equities Fund

FIGURE 4
Performance Comparison Chart

TIAA-CREF Variable Annuity	Type of holdings in fund account	1 year	5-year	10-year
CREF Accounts				
Stock	Equity	13.99%	14.27%	11.78%
Money Market	Fixed-income	5.28%	4.45%	--
Bond Market	Fixed-income	4.60%	7.14%	--
Social Choice	Balanced	14.42%	13.42%	--
Global Equities	Equity	12.61%	--	--
Growth	Equity	18.78%	--	--
Equity Index	Equity	16.26%	--	--
TIAA Variable Accounts				
Real Estate Account	Real Estate	8.235	--	--

Source: Taken from *TIAA-CREF Variable Annuity Performance Chart* as it appeared on the Internet (<http://www.tiaa-cref.org/perfcomp-chart.html>) on 6/16/97. The chart shows periodic rates of total return for the period ending 3/31/97, after all investment, administrative, and distribution expenses have been deducted and with the caveat that rates of return reflect past performance and are no guarantee of comparable future results.

ORP asset allocation: Each ORP participant determines the percentage of the total employer and employee contributions (12% of the participant's salary) to be allocated to which investment account. Participants should allocate their contributions according to their individual needs and risk tolerance. Fixed-income accounts will have less returns but also less risk, while equities offer potentially greater returns and guarantee greater risk. TIAA-CREF is responsible for enrolling ORP participants and informing them about their investment

options. A specialized report showing actual asset allocation and investment choices by Montana's ORP participants was not available.*

Education and risk: In the course of CPERS discussions about converting PERS to a DC plan or expanding the current ORP, the education and investment "savvy" of plan participants became a particular concern. While participants in a DC plan have more control over investment allocation, participants also bear the associated risks. If a participant's investment choices are unwise, the member's annuity in retirement may not be adequate to meet the participant's needs.

Portability: Portability was another issue raised in CPERS discussions about DC plans and investments. However, whether contributions or benefits are portable depends on one's definition of "portability". In the case of the ORP, the degree of portability offered depends on the contract between TIAA-CREF and the Board of Regents. Currently, when an ORP participant terminates university employment, the participant's DC plan is portable (i.e., transferable to another qualified plan without penalty) only if transferred into another plan administered by TIAA-CREF. However, even within TIAA-CREF, differences in contract provisions and employer policies mean that an employee's account may not necessarily be transferable. Finally, to protect the ORP as a plan designed to provide income in retirement, the Board of Regents has placed certain restrictions on the amount of money that may be withdrawn and under what conditions.**

Policy issues: For DC plans such as the ORP, policy issues relate to the specific provisions set by the administrative board and the negotiated with the vendor. Emerging issues for the ORP include: (1) whether the ORP should include more than one vendor (i.e., in addition to TIAA-CREF) and, if so, under what restrictions, (2) whether the University System can afford employer contribution should be raised to 6.0% and the employee contribution lowered to 6.0%

* Staff inquiries about ORP reports indicated that specific reports on Montana's participants are not available unless specifically requested by the Board of Regents. According to the Commissioner of Higher Education's benefits director, most of the assets managed by TIAA-CREF for ORP participants are in equity accounts.

** A report detailing the specific provisions of the ORP was not available.

beginning on July 1, 1997, and (3) whether portability (withdraw, transfer, and rollover) provisions should be modified. Also at issue may be how to assess the performance of TIAA-CREF, not only the investment performance of TIAA-CREF accounts, but the company's performance in educating and informing Montana's ORP participants.

Legislative Sessions and Fiscal Notes

Retirement legislation is often hotly debated during legislative sessions. Legislators during the session rely heavily on the fiscal notes that accompany the retirement bills. The Governor's Office of Budget and Program Planning, assisted by retirement system staff, prepares the final fiscal notes for all retirement legislation which have fiscal implications. Each fiscal note shows anticipated costs over the next biennium. However, the financial obligations incurred when retirement legislation is passed will be ongoing, i.e., as long as benefits are to be paid, which can extend for the life of a retired member and to that member's beneficiary.

Among the key information that legislators should look for in a fiscal note is: (1) how does the legislation affect the normal cost of benefits; and (2) how does the legislation affect system unfunded liabilities. Table 4 in Chapter 3 presented the percentage of total contributions required to fund normal costs, as well as how much of total contributions must be used to pay off unfunded liabilities. Table 4 also showed the amortization schedule for the system's unfunded liabilities given current and projected contribution rates. Whenever retirement legislation with a fiscal impact is passed and the future of the affected retirement system is changed, an actuarial calculation is required to project the long-term costs. Thus, when legislators seek to amend retirement legislation, new fiscal information can be made available only after the system's actuary has "run the numbers". This may result in action on retirement bills being delayed.

Other information that legislators may consider pertinent is the potential effect, if any, that proposed changes in one retirement system may have on other systems.

For example, if an enhanced benefit proposed for TRS participants is a good idea, is the idea also good for PERS members?

Summary

Assessing a DB plan's fiscal health is a complex affair requiring actuarial calculations to come up with composite amounts and percentages, each of which is an indicator, but not an absolute measure of system's strength or weakness. However, understanding the concepts involved in actuarial valuations, how investments are performing, and how well liabilities are funded by current assets, will help illuminate what may seem to be the "voodoo" behind how a DB plan is funded.

A sound DB plan provides a predictable benefit for employees with little investment risk to employers. A DB plan is insulated from market fluctuations, but also provides members with little control over how their funds are managed. In a DB plan employer costs fluctuate and can only be estimated through actuarial projections.

In a DC plan, employer costs are known. The sufficiency of a DC-plan benefit will depend on how wisely the employee has invested, the state of the market when the employee retires, and how well the plan's offered menu of accounts meet the individual's retirement goals.

CHAPTER 6

POLICY ISSUES AND THE CONVERSION DEBATE

Legislative policy issues will continue to encompass issues relevant to Montana's DB plans for as long as DB benefits are being paid. Additionally, conversion of public DB plans to DC plans will likely continue to be debated among public policymakers. This chapter addresses some of the key issues that are raised in most legislative debates on Montana's public retirement systems and the key issues related to moving from a DB plan toward a DC plan.

Defined Benefit Plan Issues

Creating past service debt: Past service debt relates to DB plans and is the consequence of providing a benefit enhancement and applying it to years of service already performed. Contribution rates are set based on projected costs. A benefit enhancement increases costs and if applied to service performed under lower contributions rates, a liability is created that was not included in previous cost estimates.

One way to prevent past service debt is to make a benefit enhancement applicable only to new service or to new members. However, this creates a *two-tiered* benefit structure and results in inequitable treatment of members within the same retirement system. The Montana legislature has typically applied benefit enhancements to past service.

The ratchet effect: Another policy issue involves what is termed the "ratchet effect". Just as a ratchet can be tightened but not loosened, the law requires that once a retirement benefit is promised, it cannot be reduced. If a benefit is given but is later determined to be too costly or unwarranted, the only remedy available is to enact a reduced benefit for new employees.

Although the legislature has resorted to this remedy in the past, equity and fairness issues have led subsequent legislatures to reinstate the higher benefit.

This has increased unfunded past service liabilities and overall costs beyond what the costs would have been if the benefit had never been reduced.

Benefits can be exchanged for other benefits of equal or greater value. Such "swaps" were used to help fund a portion of the costs of the 1.5% GABA enacted by the 1997 Legislature under HB 170.

Legislators are under a heavy burden to make informed and carefully considered decisions on retirement legislation. A "mistake" can rarely be fixed without enacting new provisions.

The leapfrog effect: Another policy issue is the result of having several separate retirement systems. Members of one system may lobby the legislature for a benefit enhancement one session, and if the legislature grants the enhancement, members of another system may lobby for a similar or better benefit during the next session.

Granting benefit enhancements by letting the retirement systems play leapfrog with each other can lead to inconsistent and inequitable retirement policy. To help prevent this, legislators may want to ask:

If the proposed benefit enhancement is appropriate for members of this system, is it appropriate and should it be granted for members of the other systems?

Funding benefit enhancements: A legislator asked to support a benefit enhancement may also be asked to support one of the following funding mechanisms:

- *Increasing contributions to sufficiently fund the enhancement:* Contributions should be sufficient to fund both the normal cost of the enhancement and to amortize (in 30 years or less) any unfunded past service liability. Raising employer contributions in a retirement system places an additional burden on

agency budgets. Furthermore, where local governments are the employers, increasing employer contributions may be considered an unfunded mandate.

- *Extending amortization schedules:* If contributions are not raised enough to cover costs, the system's unfunded liability will compound. A system's liabilities may be "refinanced" by extending amortization schedules. In many ways, the amortization period becomes a system's "shock absorber". Policymakers will have to consider sound policy principles to determine how far the amortization period can be extended before the system is no longer responsibly funded.*
- *Applying the enhancement only to new service:* Applying an enhancement only to future service will help control costs because no debt for past service is created. However, this option results in a tiered system in which members of the same plan will receive different benefits.

The fiscal and policy implications of each of the above funding options will depend on the fiscal strength of the affected system(s), the acceptability of extending the amortization period, and equity issues.

Defined Contribution Plan Issues

Currently, the University System's ORP is the only primary Montana public employee retirement plan that is a DC plan. Since the ORP was authorized in 1987, the legislature has had and will continue to have the responsibility of setting employer and employee contribution rates in the ORP.

Policy issues that the legislature has left to the Board of Regents to resolve include how the venter (currently TIAA-CREF) is selected, how ORP participants are educated on their options, portability/transferability provisions,

* As previously noted, the 1997 Legislature enacted statutory law in HB 170 that defines "actuarially sound basis" as requiring amortization of unfunded liabilities in 30 years or less.

and other issues mentioned in the previous chapter. These issues have remained contractual issues worked out between the Board of Regents and TIAA-CREF.

Paying DB unfunded liabilities: Among the more thorny issues is one that relates to the transfer of members from TRS (or from any of the DB plans) to the ORP and the optional or mandatory enrollment of new hires in the ORP instead of TRS. Costs and benefits in TRS are calculated based on actuarial assumptions about TRS plan members and available contributions to pay TRS unfunded liabilities. After the ORP was created, the TRS Board and the legislature required that the University System continue to make employer contributions to TRS for its ORP members at a rate that would continue to amortize the University System's share of the TRS unfunded liabilities in 40 years. This means that the University System not only makes an employer contribution to the ORP, but must also contribute to TRS a percentage of the payroll of their ORP participants.

These funding issues were hotly debated during the 1997 regular Legislative Session. The University System and the TRS Board agreed that the rate that was going to be set by the TRS board under existing law effective July 1, 1997, would be a hardship for the University System given budget constraints. Thus, by request of the TRS Board, a bill (HB 121) was introduced to phase in the higher contribution rate required to pay off the University System's portion of the TRS unfunded liabilities. Another bill (HB 142), by request of the Board of Regents, was introduced to extend the ORP to classified staff under PERS. This again raised the issue of what amount the University System should contribute toward their share of past unfunded liabilities (in this case PERS unfunded liabilities) and how that contribution amount was to be determined.* As the legislature examines moving to a DC plan, similar issues will be raised about how to pay for the DB plan's past unfunded liabilities.

* House Bill No. 121 was eventually passed as amended to phase in rate increases over 5 years. House Bill No. 142 failed on the Senate floor after having been amended several times.

Converting From a DB to a DC Plan

A directive for change: In initiating a dialogue about converting PERS to a DC plan, the 1995-1997 CPERS contracted for a report on PERS and DB/DC conversion issues. Prepared and presented to CPERS on October 26, 1996, by Mr. Leon LaBrecque and Mr. Dennis Smith, the report introduced some of the issues related to a conversion. As a follow-up to this report, CPERS requested HB 90. This bill directs that a legislative committee (i.e., CPERS) design a new or modified PERS to provide for greater plan flexibility, greater benefit portability, and more employee control and responsibility. A key component of the bill is a directive to address how plan members are to be informed and educated about their options and investment choices. It should also be noted that the bill includes language stating that a component of the new or modified plan must provide for “a specified benefit in retirement”, which suggests a hybrid DB/DC plan. The following is a key extract of HB 90:

“(2) The new or modified retirement plan must be designed to provide for the following:

- (a) increased portability of contributions;*
- (b) increased flexibility to allow plan members a choice in:*
 - (i) selecting, from a group of set amounts, the amount of the member's contribution to the retirement plan;*
 - (ii) directing investments; and*
 - (iii) selecting the form of the benefit payout; and*
- (c) a retirement plan component that will provide for a specified benefit in retirement.*

(3) (a) In designing the new or modified retirement plan, the committee shall involve employers, employees, members of the current public employees' retirement system, retirement plan administrators, policymakers, and other interested parties.

(b) The committee shall also gather and analyze information on the amount of state income tax revenue collected from the state's taxation of retirement benefits, consider this information in developing new or modified retirement

benefits, and report the committee's findings to the 56th Legislature.

(4) The committee shall establish an implementation schedule for conversion to the new or modified retirement plan. The retirement plan design and the implementation schedule, including any implementing legislation, must be presented to the 56th legislature. The retirement plan design and implementation schedule must include but is not limited to:

(a) how the new or modified retirement plan is to be administered;

(b) the costs associated with the conversion;

(c) a timetable for implementation; and

(d) a preconversion and postconversion education plan for informing policymakers, administrative staffs, executive staffs, interagency staffs, employers, employees, retirement plan members, taxpayers, and other interested parties about the new or modified retirement plan.

(5) The committee may contract for consultant services."

House Bill No. 90 appropriated \$80,000 for CPERS to use to fulfill these directives.

Options: As previously noted, PERS is a hybrid plan because it has a money purchase feature that provides members with the greater of the DB amount or a benefit amount calculated under a DC formula. The hybrid characteristics of PERS could be enhanced to provide for more flexibility and member control. For example, members could be given a menu of investment options, such as provided through the deferred compensation program or the ORP. Another option may be to provide members with a range or set of various contribution amounts. A range of other options exists to enhance the DC component of PERS.

The slate is not clean: Designing a new or modified plan does not mean that the legislature can simply start over. The contractual obligations of providing DB benefits to current PERS members is binding. Current unfunded liabilities in PERS must still be paid for because the unfunded liability amount represents the cost of benefits that have already been earned, but that cannot be paid off right

now. Furthermore, there are contractual obligations associated with the right of current working employees to continue to accrue benefits in the DB plan. These legal contractual issues need to be examined.

Finally, simply by altering the future of PERS (i.e., altering long-term actuarial projections), new actuarial liabilities will be created because assumptions about future contribution rates, investment earnings, turnover, withdrawal rates, and other economic and demographic assumptions could change drastically, depending on the nature of the changes made to the pension plan. Therefore, the actuarial impact of proposed changes needs to be assessed.

Other States

Montana is not alone in examining DC plans. California, Colorado, Iowa, Kansas, Michigan, Washington, West Virginia, and other states are examining DC alternatives, each for various reasons. Some states have made decisions, while others are still considering their options. The following summarizes what a few states have done recently.*

California: In 1996, the California Assembly passed legislation authorizing creation of DC alternatives to CALPERS, which is a DB plan. However, the Senate did not act on the legislation. Most recently, CALPERS contracted for a study to evaluate what other states are doing in this area.

Colorado: The Colorado legislature added a few features to its DB plan to make it a hybrid between a DB and a DC plan, but took no further action to convert entirely to a DC plan.

* Summary information provided by Mr. Ron Snell, Director, Economic, Fiscal & Human Resources Division, National Conference of State Legislatures, memorandum to Sheri Heffelfinger, Montana Legislative Services Division, May 27, 1997.

Kansas: The Kansas legislature has not yet acted toward converting to a DC plan, but has received a report on the matter from the state's public employees' retirement system.

Iowa: The state of Iowa recently contracted for a study of issues related to converting its public retirement plans to a DC plan. (More information will become available as soon as the final report is made public in the next few months.)

Michigan: In December 1996, Michigan adopted legislation to close its public employees' retirement system (a DB plan) and to establish a new DC plan for new employees. The legislation also opened the door for Michigan's teachers' retirement system to follow suit if that system's unfunded liabilities are paid off. Michigan's move is the topic of much discussion and analysis and should be examined further.

Washington: Washington's approach was partially examined by CPERS during the last interim and involves splitting the old DB plan into a new, dual-track plan where employer contributions are made to a DB plan and employee contributions are made to a DC plan.

West Virginia: A few years ago, West Virginia closed its teachers' retirement system and created a DC plan for new employees. However, costs associated with the conversion have been high, and according to some reports, West Virginia is reexamining its move.

Summary

Moving public retirement plans from the traditional DB plan toward a DC plan is the hot topic in many states. Many reasons have been offered in support of conversion. These reasons have typically included: (1) responding to the changing needs and dynamics of the public workforce, (2) reducing employer obligations and liabilities, and (3) giving employees more control over their own

financial futures. The extent to which a DC plan will actually accomplish these objectives has been debated and must be carefully examined. Investment companies who manage individual investments for a living strongly advocate DC plans, while those associated with DB plans in the public sector tend to be skeptical of DC plans and maintain that DB plans are working very well, so “if it ain’t broke?”

Montana’s legislators are challenged to sort through the issues and arguments and to enact sound public retirement policy. The policy ultimately enacted will affect public employees, employers, and retirees, now and for generations to come.

CHAPTER 7

POLICY PRINCIPLES

Need for Policy Principles

As mentioned in the introduction, the Montana Legislature has recognized a need for sound and consistent retirement policy. Regardless of the PERS conversion and modification issues discussed in the previous chapter, CPERS has been given the responsibility of adopting sound policy principles to guide legislative decisionmaking on retirement legislation. This chapter provides the history and current status of some basic retirement policy principles.

National Conference for State Legislatures' Principles

The Public Pension Working Group of the National Conference of State Legislatures (NCSL) has adopted and recommended to state legislatures four principles for sound and consistent retirement policy.*

1. *Pensions should provide financial security in retirement.*

Retirement should be defined as the completion of a working career, not the end of employment under a system.

Financial security should be viewed in terms of the minimum benefit required for a retiree to enjoy reasonable financial security in his or her later years. The benefit should reward the retiree's years of public service.

*National Conference of State Legislatures, *Public Pensions: A Legislator's Guide*, NCSL, Working Group on Pensions, 1995.

2. Pension funding should be a contemporary obligation.

Retirement benefits should be paid for at the time the service is being performed, not by future taxpayers or contributors. *(Guidelines adopted by the Teachers' and Public Employees' Retirement Boards provide that unfunded liabilities should be amortized in 30 years or less. The 1997 Legislature adopted an amendment to HB 170 that statutorily requires that any new unfunded liabilities within PERS must be amortized in 30 years or less.)*

3. Pension investments should be governed by the "prudent expert rule".

Investments should be carried out according to accepted standards that emphasize prudence, discretion, and intelligence and that discourage speculation. Prudent investments protect capital and maximize earnings.

4. Pension benefits should be equitably allocated among beneficiaries.

This principle is aimed at preventing discrimination against any group of employees based on occupation, marital status, tenure, salary, hire date, etc. This principle is also designed to prevent discrimination between retirement systems and among members of the same system.

History of Principles and Policy Guidelines

The 1993-1994 Joint Subcommittee on Public Employee Retirement Systems:

This committee discussed and adopted the second, third, and fourth principles recommended by the NCSL public pension working group as listed above.

However, the committee failed to reach agreement on the first principle due to different interpretations of the principle's meaning and what should be the purpose of Montana's public pension plans.

The 1995-1997 CPERS: The 1995-1997 CPERS adopted the NCSL guiding principles listed above, but with a modified version of the first principle. The modified principle was adopted as follows:

(1) *Pensions should provide a base.* (Note that this principle is a modified version of the NCSL principle. Committee discussions revealed different interpretations of what “financial security” or “financial base” means and what “in retirement” means. Thus, the principle as adopted does not contain any references to financial security or financial base in retirement.)

Summary

Principles are useful to the extent that they help guide decisionmaking toward consistent and sound policy. The Montana legislature has directed that CPERS be the body to develop and adopt policy principles that will best assist the legislature as it sets long-term policy on Montana’s public employee retirement systems.

Review

This guide has presented a breakdown of the two categories of retirement plans (DB and DC plans) and the different types within each category. Chapter 3 and Chapter 4 provided a more detailed discussion of Montana’s retirement plans compared to each other and actuarial trends. Chapter 5 presented information in actuarial valuations on indicators of fiscal strength or weakness in the retirement plans and investments. Chapter 6 discussed policy issues, including those related to converting from a DB plan to a DC plan. Finally, Chapter 7 summarized basic policy principles previously adopted to assist legislative decisionmaking. It is the hope of CPERS and the legislative staff that this guide has provided information useful to the policymaking process.

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